

TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: 2002-2003 Investment Branch Objectives Results Matrix ITEM NUMBER: 8

ATTACHMENTS: 1

ACTION: _____

DATE OF MEETING: July 9, 2003

INFORMATION: X

PRESENTER: Christopher J. Ailman

Executive Summary

To close out the fiscal year, Attachment 1 is a review of the results of 2002-2003 Investment Objectives and Work Plan. All of the objectives have been completed or will soon be completed.

Discussion

Staff worked very hard to complete the objectives set by the Committee in July 2002. This was evidenced by the Investment Committee agenda and meetings being very full and robust. Overall, staff is pleased to report, 16 of the 18 items were completed and the two remaining projects were commenced in the past year and are expected to be completed early next fiscal year. Under prior Committee practice, these are considered completed once an objective has been commenced. This view is based upon the experience that the ultimate conclusion on a project could not be forecasted.

OTHER ACHIEVEMENTS

Asset Allocation

The overall investment environment, in the past fiscal year, was quite a challenge with the third year of a prolonged global economic slowdown and major geopolitical crisis. As has been said many times, the world and our lives all changed with the tragedy of September 11, 2001. However, as a result of the bold action taken by the senior investment staff to rebalance the portfolio in the fall and early spring, the Fund was well positioned to capture the global equity rally in May and June. As a result, we have finished the year with a positive return. The CalSTRS investment staff was one of only a few pension plans to step back into the market at the low points of October 2002 and March 2003.

Barton Biggs of Morgan Stanley wrote in his weekly research report that after a tour of the nation in the late spring, only two of twelve large institutional investors he visited had re-entered the market; CalSTRS was one of the two. In his own words the other investment staff seemed paralyzed by the sting of the prolonged bear market and only a couple showed the conviction to take action in the face of a mountain of worries and geopolitical strife. By buying on dips in the U.S. equity market, the investment staff has earned the Fund an extra \$575 million in value.

While this success story is at the asset allocation level, there are several success stories within the various asset classes. Within the fixed income's "year of transition" from one benchmark to another, Carol Merlini, our mortgage backed portfolio manager, has not only efficiently modified her portfolio, but she also added significant value by her decisions. With a team of three other investment officers, Carol has full discretion over our \$ 8.6 billion mortgaged portfolio. As of the one-year ending April 30, the team has outperformed their benchmark by over 80 basis points, which represents a profit to CalSTRS of nearly \$70 million. The total fixed income portfolio ranks in the 8th percentile relative to similar core portfolios over the past year.

CalSTRS Core Values

Customer service – While the investment staff does not often interact directly with our members, the Chief Investment Officer did meet several times with major constituent groups. In the spring the CIO reviewed the asset allocation process with the client advisory group. In May, the CIO was a guest speaker (and very well received) at the CRTA annual conference where discussion of the past and future of the investment portfolio took place. More recently, the CIO spoke at the annual CASBO leaders meeting

Accountability – The investment staff set the national standard, on disclosure of IRRs in private equity. While other large State plans have taken credit in the press, CalSTRS was the first to respond while others were still fighting in court. Working closely with our legal staff, the alternative investment staff was able to walk the tight line between the private and public investment arenas. Staff also took proactive steps to place the entire investment portfolio on the CalSTRS Web site.

Leadership – The investment staff has assumed a major leadership position within the investment industry. Staff serves an active role on both the Russell Index Advisory group and the Lehman Aggregate Index Board. Each is the leading index provider for U.S. equity and fixed income, respectively. Additionally, the CIO has served on the board of Directors for the Pacific Pension Institute which strives to provide an educational forum to bridge the Pacific Rim for pension investors. Additionally, the CIO serves on the program advisory panel for the Pension Board Investment Forum, and for the past 6 years, has attended the IFE's Market Makers conference.

Strength – The Investment staff has followed the Board's lead and taken strong steps to embrace diversity within the investment portfolio and within staff. Staff took the initiative to propose an emerging manager program for the U.S. equity program that will further enhance the diversity of the CalSTRS external manager pool. CalSTRS has a deep history of hiring diverse managers and that continues with the selection and funding of a woman owned high yield bond manager and Canyon/Johnson (Magic Johnson) real estate fund. Staff has also made use of student interns from all over the globe and schools as far away as Xavier University. These students' home countries included the U.K., Philippines, Taiwan, and China. To reach out to the industry, the senior investment staff hosted a lunch with the Toigo Foundation for minority investment

professionals. The CIO serves as an active member of the Toigo Foundation Advisory Board which strives to change the face of the investment management industry.

Trust – Core to any investment program is building the trust of the members, the Board and the public. CalSTRS' proactive stance on corporate governance, and open and visible presence in the face of a bear market, helped build upon the trust already earned by the Investment Branch. To help build trust with the Board, staff has actively expanded the monthly reporting to include better data and risk information. In addition, staff added the internal fixed income portfolio to the monthly reports to give the Board even greater visibility into the monthly activities of the unit. Integrity is the cornerstone of our Branch. Our team traders and portfolio managers commit millions of dollars over the phone where your word is your bond is transacted.

Respect – This past summer the senior staff asked the Investment Branch to develop a list of core values specifically for the Branch. In the view of the senior staff, values must be forged from the group, not forced down from management. Respect was the number one core value selected across the entire Branch. The standard adopted was not the golden rule, but rather the platinum rule which is to treat others not as you would like, but as *they* would like to be treated.

Stewardship – Our fiduciary responsibility is at the core of each and every investment recommendation or decision. Our corporate governance and securities litigation programs are prime examples of stewardship in action. Far from the spotlight, is staff work to improve the terms and conditions of partnerships and contracts. In the past year, staff with the help of the legal office, consultants, and outside counsel was able to significantly improve CalSTRS' position in several real estate joint ventures and private equity partnerships. In the Nogales transaction, CalSTRS' negotiation efforts improved the partnership to the benefit of the other limited partners that include CalPERS and New York Common. In the CIM Real Estate Fund, staff negotiation again saved CalSTRS and CalPERS significant fees and greater protections.

This is just a partial list of successes and profits generated by the Investment staff's hard work and sound judgment. Greater strides can still be attained and the staff will aggressively model and pursue the CalSTRS core values, goals, and objectives in the next fiscal-year.

Respectfully submitted,



Christopher J. Ailman
Chief Investment Officer

**INVESTMENT BRANCH
2002 – 2003 INVESTMENT OBJECTIVES**

DIVISION	DESCRIPTION	SEMESTER	STATUS
ALTERNATIVE INVESTMENTS	Implement Committee plan for private equity investments in under served urban and rural communities.	FALL	Completed <input checked="" type="checkbox"/>
CREDIT ENHANCEMENT	Present a comprehensive Annual Report on the Credit Enhancement Program.	SPRING	Completed <input checked="" type="checkbox"/>
EXTERNAL EQUITY	Present a Semi-annual report rating the investment managers.	FALL & SPRING	Completed <input checked="" type="checkbox"/>
	Explore, evaluate, and present an analysis regarding the selection of emerging market countries for investment.	FALL	Commenced and soon to be completed <input checked="" type="checkbox"/>
	Evaluate and present an analysis on the active equity allocation to determine the appropriate active/passive split.	SPRING	Completed <input checked="" type="checkbox"/>
	Study and evaluate the creation of small / emerging active equity managers program.	SPRING	Completed <input checked="" type="checkbox"/>
CORPORATE GOVERNANCE	Pursue broad market reforms and work-plan companies	FALL & SPRING	Completed <input checked="" type="checkbox"/>
INTERNAL EQUITY	Present an annual report to the Investment Committee that reviews the status of the Cash Equitization program.	SPRING	Completed <input checked="" type="checkbox"/>
FIXED INCOME LONG TERM	Present status report on High Yield managers and changes to the fixed income portfolio.	SPRING	Completed <input checked="" type="checkbox"/>
HOME LOAN	Present an annual report on the Home Loan Program.	SPRING	Completed <input checked="" type="checkbox"/>

**INVESTMENT BRANCH
2002 – 2003 INVESTMENT OBJECTIVES**

DIVISION	DESCRIPTION	SEMESTER	STATUS
INVESTMENT OPERATIONS	Present a report on straight through processing readiness	SPRING	Completed <input checked="" type="checkbox"/>
REAL ESTATE	Implement plan for urban real estate and affordable housing investments.	FALL	Completed <input checked="" type="checkbox"/>
SECURITIES LENDING	Present an Annual Report on the program	SPRING	Completed <input checked="" type="checkbox"/>
SOFT DOLLAR	Present a financial statement report to the Investment Committee as part of the Semi-annual Budget report.	SPRING	Completed <input checked="" type="checkbox"/>
GENERAL – (CIO)	Complete a stochastic asset liability study.	SPRING	Commenced and soon to be completed <input checked="" type="checkbox"/>
	Present the semi-annual report as required by the California investment policy.	FALL & SPRING	Completed <input checked="" type="checkbox"/>
	Orient new Board members and assist the Committee with the pension governance review.	SPRING	Completed <input checked="" type="checkbox"/>
	Revise the Investment Management Plan to reflect the modifications (if any) in the strategic asset allocation, investment objectives, and investment structure.	SPRING	Completed <input checked="" type="checkbox"/>